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*"Strengthening Social Security: Can We Learn from Other Nations?"*

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## (A) In a nutshell: The German social security system through American eyes

Given the large variety of pension systems in the world, the German and US systems are close to identical in their fundamentals:

- In both countries, public pensions are the main income source for most elderly, and about the only formal retirement income source for the lower third of the income distribution.
- Both systems are financed pay-as-you-go. There are no real assets backing up future claims on benefits.
- Both systems are earnings related (benefits increase with earnings, other income sources not included). Benefits are defined by a benefit formula which converts [a close approximation of] life time earnings to annual pension benefits.

The main differences are redistribution and program generosity:

- The German system redistributes less from rich to poor (benefits are proportional to AIME, there is no progressive PIA conversion as an intermediate benefit computation step)
- The German system is considerably more generous on average. Generosity takes three forms: it permits earlier retirement (on average: 3.1 years earlier; no actuarial adjustments); it provides higher replacement rates (70% rather than 53% for mean productive worker); and it indexes pensions by wages (rather than COLA).
- Germany faces a considerably more severe aging problem (current dependency ratio equals that of the US in about 2025; in 2035 about twice as high as in US. Reason is a particularly pronounced birth dearth in the early 70s – in about 5 years from 2.4 children to 1.3 children

per woman, US 2.0 children, and a steadily increasing life expectancy – now at 77.7 years, US 76.7 years).

- The last two points amplify each other and imply that pension expenditures take about 2.5 times more of GDP than in the US (11.8% of GDP rather than 4.4%)
- Two technical details are important to understand the political process: (a) Since there are no sizable reserves, the German system is vulnerable to business cycle fluctuations. This has sparked the 2002 crisis. (b) Benefits are re-calculated every calendar year for all pensioners ("annual pension increases"), hence cohorts are not locked-in at a certain program generosity. This gives program changes a much stronger leverage than in a "new entrants' system" because the "annual pension increase" affects the entire stock.

## (B) The recent German reform process

Four major events: (1) the "Riester Reform" in 2001; (2) the budget crisis in 2002; (3) the proposals of the "Rürup-Commission" in 2003; and (4) the "Sustainability Law" passed by the Bundestag in early March of 2004.

The process produced two crucial reform elements: (1) the introduction of a formal third pillar with subsidized individual accounts ("Riester pensions") in 2001, and (2) the indexation of future pension benefits to the ratio of pensioners to workers ("Sustainability factor") in 2004.

### 2001 "Riester Reform":

(a) Introduced tax-privileged private retirement savings ("Riester pensions" in individual accounts, comparable to tax- privileged IRAs), heavily subsidized for the poor (1:1 matching by the government) and highly regulated (forced annuitization). Goal: Induce private retirement savings equal to 4% of gross earnings.

(b) Reduced *all* public pension benefits in proportion to the *hypothetical* uptake of Riester pensions ("Riester steps"). Goal: Reduce average net replacement rate from 70% in 1999 to 64% in 2030.

(c) Introduced non-earnings-related minimum pension for all persons. Benefits equal social assistance level plus 15%.

**2002 Budget Crisis:**

Reserves were exhausted due to unexpectedly severe business cycle downturn. Contribution rates needed to be increased from 19.1 to 19.5% of gross earnings rather than decreased as was scheduled. This sparked a coalition crisis and the installment of a high level reform commission. At the same time, the uptake of Riester pensions was minimal (it was not much better in 2003 and is now considered a failure).

**2003 Proposals by "Rürup-Commission on Sustainability in Financing Social Security":**

Mixture of a political and a technical commission (members were: (1) administration and politicians, (2) union and employers association representatives, (3) scientists; about a third each). Cleavages are not partisan but between unions and government, and, less so, within the government between young and reformist green party members and older more conservative social democrats.

(a) Reduce public pension benefits in a "rational and transparent fashion" by relating annual pension increases to a weighted mixture of increases in (1) wages and (2) system dependency ratio (ratio of full time equivalent pensioners to full time equivalent contributors). "Rational and transparent" refers to the fact that the budget of a pay-as-you-go system is fundamentally determined by the number of pensioners on the one hand (expenditures) and the number of contributors on the other hand (receipts); it also reflects the dissatisfaction with the 2001 Riester reform which related pension benefit cuts to the hypothetical uptake of private accounts which never actually took place.

(b) Increase normal retirement age from 65 to 67, increase early eligibility age from 60 to 64.

(c) Simplify regulation of private retirement savings to increase uptake.

Only (a) becomes immediately law:

**2004 “Sustainability Law”:**

Indexation to system dependency ratio becomes law, effective from January 2005 on. This new element introduced into the benefit indexation formula is dubbed “sustainability factor”.

This step effectively converts the German defined benefits system (contribution rate set to finance promised benefit levels) to a “notional” defined contributions system (financial possibilities at given contribution rate dictate benefit levels). The economics of the new German system are very similar to the “notional defined contribution” system in Sweden, although the accounting mechanics are quite different.

The indexation to the system dependency ratio will decrease the average net replacement rate from 70% in 1999 to about 60% in 2030, hence the recent reform deepens the Riester benefit cuts by another 4 percent points. The system is self-stabilizing, that is, higher than expected fertility and labor force participation will increase pension benefits relative to current projections, while higher life expectancy will automatically decrease pension benefits.

The other proposals of the “Rürup-Commission” were not taken up in the 2004 Sustainability Law. Legislation for simplified regulation of private pensions is under way, likely to be passed before this summer. The highly unpopular legislation on later retirement ages, however, was postponed until after the next elections, but it is expected to become law after a formal review of pension system which is scheduled for 2008.

**(C) Main Lessons**

Indexation to system dependency ratio (in addition to indexation to wages or COLA) provided a politically feasible mechanism for benefit cuts. The mechanics of the “sustainability factor” are simpler to communicate than discretionary benefit cuts. The “sustainability factor” provides automatic budget stabilization features. The resulting pension gap is sizable (about a 15% benefit cut) but it should and can be filled by IRA-type private or occupational pensions at moderate contribution rates (about 4% of earnings for older cohorts, 2.5% for younger cohorts); uptake, however, has been very sluggish so far.